Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-1433-99
JEKagy

date: MAY 14 1999

to: Chief, Appeals Division, Ohio District
Attn: Rick O'Connor

from: Assistant District Counsel, Ohio District

subject: [redacted]

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

On March 31, 1999, we issued a memorandum addressing questions raised in your March 1, 1999 correspondence regarding a worthless securities deduction claimed by [redacted] as an ordinary loss pursuant to section 165(g)(3). Since we issued our memorandum, an additional potential issue has been identified that we believe should be called to your attention.

We recently learned that [redacted] became part of the [redacted] consolidated return for the [redacted] tax year. Since [redacted] was a member of the consolidated return in [redacted], the worthless securities loss claimed raises potential issues under the loss disallowance rules of Treas. Reg. § 1.1502-20. In the most general of terms, the loss disallowance rules disallow a loss on

the disposition of stock of a member of a consolidated group. Thus, in this instance, the loss disallowance rules may provide an additional reason for the disallowance of the taxpayer's claimed worthless securities loss. We emphasize the word "may" because of, among other things, the loss disallowance limitations set forth in Treas. Reg. § 1.1502-20(c). This is an issue of first impression, and we recommend the submission of the issue to National Office in the form of a request for Field Service Advice prior to the issuance of the statutory notice. Should you or the agents wish additional information concerning this potential issue, you can contact District Counsel or Attorney Jerry Fleming in the Corporate Branch of Field Service.

Finally, we note in passing that Examination should be alerted to scrutinize the succeeding tax years' returns to make sure that any unused [redacted] NOL not be allowed to be used to offset income in a manner contrary to the separate return loss year (SRLY) limitations. Moreover, because of the ownership change effected when [redacted] became the sole shareholder of [redacted], the amount of post-change income of [redacted] which may be off-set by pre-change losses is limited by IRC § 382. Although these issues are peripheral and fairly obvious, we thought we would mention them just to be safe.

If we can be of further assistance in this matter, please contact the undersigned at ext. 3211.

MATTHEW J. FRITZ
Assistant District Counsel

By: (Signed) James E. Kagy
JAMES E. KAGY
Special Litigation
Assistant

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-1433-99
JEKagy

date: MAR 31 1999

to: Chief, Appeals Division, Ohio District
Attn: Rick O'Connor

from: Assistant District Counsel, Ohio District

subject: [redacted]

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This correspondence addresses the questions raised in your March 1, 1999 memorandum regarding a worthless securities deduction claimed by [redacted] as an ordinary loss pursuant to section 165(g)(3).

ISSUES:

1. Whether District Counsel would approve the issuance of a Statutory Notice of Deficiency based strictly upon the facts stated within Appeals' March 1, 1999 Memor

2. Whether District Counsel supports the return of the case to the District for further factual development prior to the issuance of any Statutory Notice of Deficiency.

3. Whether District Counsel supports the execution of a partial agreement resolving most of the other issues raised by Examination and, if so, whether District Counsel advises that the agreement should be executed prior to the issuance of a Statutory Notice of Deficiency.

CONCLUSIONS:

1. We are unable to indicate approval of a Statutory Notice of Deficiency without a review of the complete Administrative File. Nevertheless, our "gut reaction" to the facts described in your memorandum is that the issue possesses very serious merit and should be pursued.

2. Without a complete review of the Administrative File, we can only advise that if time permits and further factual development is both necessary and reasonably possible, the matter should be returned to Examination for completion of the necessary audit work prior to the issuance of the Statutory Notice of Deficiency.

3. For the sake of the orderly and efficient administration of the case, to the extent you have reached agreement with the taxpayer regarding some or most of the issues raised by Examination, we advise that you complete the execution of any partial agreements prior to the issuance of the Statutory Notice of Deficiency.

FACTS:

In [redacted], [redacted] ("[redacted]") was a small, independent company which had been doing business as [redacted] since at least [redacted]. Its business consisted of producing, [redacted] and distributing [redacted]. It operated out of a [redacted] leased space of less than [redacted] square feet. For its tax years ended [redacted] and [redacted], [redacted] showed taxable income of only $[redacted] and $[redacted]. In [redacted], [redacted] registered the trademark "[redacted]" and by then was serving an established market in [redacted]. Its books for the tax year ended [redacted] reflected taxable income of ($[redacted]).

In [redacted], [redacted] ("[redacted]") purchased [redacted]% of the outstanding common stock of [redacted] directly from the existing shareholders for a cash payment of $[redacted]. Simultaneously, [redacted] purchased [redacted]% of the existing

[redacted] preferred stock from the existing shareholders for $[redacted] and [redacted]% of newly issued [redacted] preferred stock from the corporation for $[redacted]. [redacted] also agreed to loan [redacted] up to $[redacted]. Any loan disbursements made to [redacted] would be secured by the shares of [redacted] still held by the original shareholders, thus representing the remaining [redacted]% interest in [redacted].

Following the stock purchase by [redacted], [redacted] apparently continued to serve the same [redacted] market. [redacted] apparently advanced [redacted] dollars pursuant to the loan agreement and [redacted] appears to have met its principal and interest obligations under the loan agreement. For the tax years ended [redacted] and [redacted] reported taxable income of ($[redacted]) and ($[redacted]), respectively. In addition, [redacted] reported taxable income for the period ended [redacted] of ($[redacted].

In [redacted], [redacted] registered the trademark "[redacted]", but it is unclear whether this trademark was used by [redacted] in its business. For the period ended [redacted], [redacted] reported taxable income of ($[redacted]). On that date, with [redacted] owing [redacted] approximately $[redacted] as a result of disbursements made pursuant to the loan agreement, [redacted] defaulted on its loan. [redacted] seized the loan's collateral, becoming the sole shareholder of the [redacted] stock. Considering [redacted] books reflect additional taxable income of ($[redacted]) for the period ending [redacted], it is assumed that [redacted] continued to do business as a wholly owned subsidiary of [redacted] throughout the remainder of [redacted], following its default on the [redacted] loan.

In [redacted], [redacted] acquired [redacted] ("[redacted]"), pursuant to a stock acquisition from an unrelated company. [redacted] was [redacted] manufacturer and [redacted], operating out of a [redacted] square foot leased facility in [redacted].

According to the taxpayer, in [redacted], [redacted] decided to cease operations and combine its production facilities with [redacted]. By [redacted], [redacted] is reported to have abandoned its leased space, sold some of its delivery equipment to unrelated third parties, transferred its production equipment and other fixed assets to [redacted] and terminated the employment of most, if not all, of its former employees.

In [redacted], a merger agreement was executed between [redacted] and [redacted], with the surviving corporation changing its name to [redacted] ("[redacted]"). Although not executed until [redacted], the merger was made retroactive to [redacted]. Thereafter, [redacted] operated

out of the facilities originally leased by [redacted] and produced, [redacted] and distributed [redacted]. [redacted] continued to [redacted] and sell [redacted] bearing the "[redacted]" trademark, and it may have continued to use other intangible assets originally created by [redacted] such as its customer lists, formulas, and other trademarks. Sometime in [redacted], [redacted] or [redacted] applied for a trademark for the "[redacted]" name, but the trademark may not have been used extensively, if at all, during the [redacted] tax year.

As part of its [redacted] tax return, [redacted] claimed a worthless securities loss for the value of its stock in [redacted]. [redacted] claimed that [redacted] was insolvent in [redacted] and that, as a result, the stock in [redacted] became worthless in [redacted]. To support its assertion, [redacted] has provided the Service with an appraisal, dated [redacted], performed by [redacted] which purports to value [redacted]'s assets as of [redacted]. The report apparently reflects two things regarding the valuation date: (1) the book value of the company's assets exceeded liabilities (once the $[redacted] debt was reclassified as equity) and (2) the liabilities exceeded assets by $[redacted], once the assets were written down to reflect an orderly liquidation. The appraisal neither made an attempt to value, nor ascribed a value to, any of the intangible assets held by [redacted].

Based upon the above facts, and relying heavily on an in-house engineer's report critiquing the methodology used by the [redacted] appraisal and the report's failure to value any of the intangible assets of [redacted], Examination challenged the worthless securities claim. Examination posits that the taxpayer has failed to establish that the securities were worthless in [redacted]. Appeals believes that, in addition to the issue articulated by Examination, the Service could also argue that, in the alternative, even if the securities were worthless on [redacted], the taxpayer failed to establish that the securities were not also worthless the prior day, that is, the day before [redacted] acquired the requisite 80% control necessary under the section 165 regulations to establish, as an ordinary loss, its worthless securities claim.

LEGAL ANALYSIS:

As a general matter, a taxpayer who owns stock, which is a capital asset, is entitled to a capital loss in the year the stock becomes wholly worthless. I.R.C. §§ 165(a), (g)(1) and (g)(2)(A). However, a loss incurred by a domestic corporation on wholly worthless stock in an affiliate corporation may be converted from a capital loss to an ordinary loss. Treas. Reg.

§ 1.165-5(d)(1). Stock is worthless if it has neither liquidating value nor potential value. Austin Co. Commissioner, 71 T.C. 955, 970 (1979). In that regard, a corporation's stock has liquidating value if its assets exceed its liabilities. Id. The mere shrinkage in the value of stock, however, even though extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value on the date claimed as the date of loss. Treas. Reg. § 1.165-4(a). Similarly, a corporation's stock has potential value if there is a reasonable expectation that it will become valuable in the future. Steadman v. Commissioner, 50 T.C. 369, 376-377 (1968), aff'd, 424 F.2d 1 (6th Cir. 1979); Morton v. Commissioner, 38 B.T.A. 1270, 1278 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940). In establishing worthlessness, however, the taxpayer is not required to be an "incorrigible optimist". See United States v. S.S. White Dental Mfg. Co., 274 U.S. 398 (1927).

As a matter of proof, worthlessness has historically been considered a question of fact for which the petitioner bore the burden of proof. See Boehm v. Commissioner, 326 U.S. 287, 294 (1945). The standard for determining whether a stock is worthless varies according to the circumstances of each case. Id. In Morton v. Commissioner, the court set forth the following, often quoted standard for deciding worthlessness:

> [S]tock may not be considered as worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time ... such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of the corporation, or the appointment of a receiver for it. Such events are called "identifiable" in that they are likely to be immediately known by everyone having an interest by way of stock holdings or otherwise in the affairs of the corporation; but, regardless of the adjective used to describe them, they are important for tax purposes because they limit or destroy the potential value of the stock.
>
> The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has liquidating value. If its assets are less than its liabilities but there is a

> reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has potential value and can not be said to be worthless. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.

Morton, 38 B.T.A. at 1278-1279.

Other case law, however, tends to muddy the waters a great deal. For instance, as to the establishment of worthlessness, it has been determined that, generally, the mere fact of a sale after the purported date of insolvency does not necessarily preclude a finding that the stock was not worthless. As one court stated: "A loss is not any less definite and ascertained because in a later year someone is willing to take a 'flyer' on it at a nominal price." Keeney v. Commissioner, 116 F.2d 401 (2nd Cir. 1940); Pearsall v. Commissioner, 10 B.T.A. 467 (1928). Neither does the continued operation of a corporation prove the stock has value. See Rand v. Commissioner, 40 B.T.A. 233 (1939), aff'd, 116 F.2d 929 (8th Cir.), cert. denied, 313 U.S. 594 (1941). See also, Rev. Rul. 70-489 1979-2 C.B. 53 (a creditor-parent who takes over the assets of a wholly owned subsidiary in a statutory merger and continues to operate the sub's business as a branch is still entitled to a deduction for the resulting bad debts and worthless securities). Further, the occurrence of bankruptcy in one year does not preclude a finding of worthlessness in an earlier year, based upon corporate insolvency. See Polizzi v. Commissioner, 265 F.2d 498 (6th Cir. 1959).

APPLICATION:

Clearly, the determination of worthlessness is an intensely factual matter. Above, we have attempted to briefly articulate the general legal touchstones, to the extent they exist, upon which the resolution of the issue will be based, and more importantly, the legal questions which Appeals or the Tax Court must be able to resolve from application of the factual evidence before it. Without a comprehensive study of the Administrative File, we cannot judge the amount or strength of the factual evidence gathered by Examination. We cannot opine, therefore on whether we would support the issuance of a Statutory Notice of Deficiency on the section 165 worthless securities issue.

From the facts portrayed by your memorandum, we believe serious factual questions exist concerning not only whether [redacted] lacked liquidating value, but whether it lacked potential value. As to liquidating value, for litigation, the Service would need an outside expert to independently determine the fair market value of the assets of [redacted] as of the valuation date. We understand that Examination's position is based not on an outside expert, but on an analysis prepared by one of our in-house engineers. Parenthetically, given who our engineer was, we trust that the Service's position will be borne out by an outside expert. Nevertheless, it may well be possible that, considering the facts encountered by [redacted], the outside expert will agree that a "liquidation value" is appropriate. Only an in-depth review and analysis of the engineer's work papers would permit a determination of the proper reliance which may be placed on the Service's current position. We cannot make such a judgment from your write-up.

Moreover, as to potential value, we saw nothing in your memorandum upon which to base an opinion regarding the existence of the potential value of the company, or the lack thereof. The file must contain a detailed statement of the "identifiable event" identified by the taxpayer as establishing or triggering the lack of potential value of [redacted]. One possible "identifiable event" might be the decision to default on the intercompany loan. From a factual standpoint, it is imperative that the file address the facts surrounding the default of the loan. All contemporaneous documentation in existence concerning the basis of the decision to default should be contained within the file. Such documentation should include all forecasts, studies, reports, opinions, analyses, memoranda, or other contemporaneous correspondence prepared by, for or on behalf of [redacted] (or any [redacted] entity) regarding the decision to default on the loan. The file must determine the identities of parties making the decision, and contain as complete of a history of the decision as is possible. To that extent, all Board Minutes, CEO Reports, CFO Reports, and similar historical internal documentation for the period preceding, as well as following, the decision to default should be in the file.

To determine the potential strengths and weaknesses of the issue, we need to know as much as we possibly can about the original shareholders in [redacted]. Why did they enter into the deal to begin with? Did we interview them? Were they just cashing out of a family business? Was the whole arrangement just a financing mechanism to avoid tax? What type of sales projections did they have going into the deal? Did they believe [redacted] was insolvent and worthless when their stock was seized? How about before it was seized? How was the decision made by [redacted] to stop

paying on the loan? Who made it? Did they agree with the decision?

The file should also contain interviews with the former owners of [redacted]. What did they know about the transactions, the motives of [redacted], the solvency of [redacted] or the value of its assets?

The file should contain copies of the merger documents themselves and all valuations, appraisals of assets, studies, reports or other memoranda like Board of Directors Minutes or CEO reports, outlining the planning process behind the merger of [redacted] and [redacted]. Factually, it is imperative that the merger be fully analyzed and dissected. We must fully understand the assets contributed, the strengths of the parties and all consideration that passed. For instance, if the structure of the merger was the contribution of both corporations' stock for a certain number of shares of stock in [redacted], the surviving corporation, it can be argued that since value was received for the [redacted] stock it must not have been worthless. See Delk v. Commissioner, 113 F.3d 984 (9th Cir. 1997).

Depending on the evidence described in the preceding several paragraphs, the Service may be able to argue that: (1) [redacted] was solvent on [redacted], and that no worthless security loss is appropriate, or (2) if, in fact, [redacted] was insolvent on [redacted], it was equally insolvent the prior day, week or even year, and since any worthless security loss arose during a time when [redacted] did not own 80% of all classes of [redacted] stock, any loss would be capital in nature. See Treas. Reg. § 1.165(g)(3). For instance, if the triggering event was the default of the loans, such default preceded the seizure of the original shareholders' [redacted]% interest in the corporation. A logical argument stemming from that occurrence would be that [redacted] was already worthless before [redacted] owned more than 80% of the value of each class of stock in [redacted].

In that regard, the analysis of the "identifiable event" alleged by the taxpayer may be essential. [redacted] had operated at a loss for years prior to its claimed insolvency. What happened during [redacted] that eliminated all reasonable hope and expectation that it would become valuable in the future? Here, [redacted] corporate charter had not been seized, revoked or abandoned, their loan from [redacted] had not been called, their assets had not been seized and they had not declared bankruptcy. Your memorandum does not elaborate on the "identifiable event" claimed by the taxpayer. To the extent the agent's files are silent on the points concerning the "identifiable event", the Service's litigation of the worthless securities issue may be severely

handicapped. Depending on the facts, this may turn into a case like that in Ainsley Corp. v. Commissioner, 332 F.2d 555, 557 (9th Cir. 1964) where that taxpayer's subsidiary not only never had an operating profit, but had a history of several years of uninterrupted and "ruinous" losses. See also, Steadman v. Commissioner, 50 T.C. 369 (1968). On different facts, the case could appear more like that in Figgie International Inc. v. Commissioner, 807 F.2d 59, 62-63 (6th Cir. 1986) where the Court concluded that the subsidiary's stock "clearly had potential value". As is obvious, the conclusions reached by the Courts turn on the specific facts of each case. If the facts in this case are undeveloped, the case should be sent back for further factual development if the time and resources are available.

At this time, only Appeals is in a position to determine whether the facts contained in the Administrative File establish whether [redacted] either was solvent on [redacted] or, if insolvent, was also insolvent prior to [redacted]'s obtaining the requisite 80% of the value of all classes of stock in [redacted]. Similarly, only Appeals is in a position to determine whether additional factual development is required before the issuance of a Statutory Notice of Deficiency. We generally counsel against the issuance of a Statutory Notice of Deficiency based upon an unsupported, unsupportable or seriously undeveloped position. Given the factually intensive nature of issues such as these, we cannot counsel too strongly the need to factually develop these issues to the full extent of the time and resources available.

If we can be of further assistance in this matter, please contact the undersigned at ext. 3211.

MATTHEW J. FRITZ
Assistant District Counsel

By: James E Kagy
JAMES E. KAGY
Special Litigation
Assistant